

DOCUMENT RESUME

ED 308 607

EA 021 106

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TITLE A Look at Self-Insurance through Pooling and Capital Market Funding.
PUB DATE May 89
NOTE 11p.
PUB TYPE Information Analyses (070) -- Guides - Non-Classroom Use (055)

EDRS PRICE MF01/PC01 Plus Postage.
DESCRIPTORS *Bond Issues; Capital; *Educational Finance; Elementary Secondary Education; *Financial Support; *Insurance; *School Districts
IDENTIFIERS *Self Insurance

ABSTRACT

One alternative to the insurance crisis faced by school districts is self-insurance, either through pooling or capital market funding. After a brief discussion of the insurance issue, research and literature dealing specifically with self-insurance through pooling and capital market funding are described. Finally, an assesment is made of the various alternatives, and several considerations are presented. In the ideal situation, self-insurance is established on an individual basis through market funding. Pools are a viable alternative if the pools are set up and managed carefully. The best funding method for self-insurance programs, whether independent or pools, is to capitalize the program through a bond issue. The one threat in the capital market approach is the catastrophic claim that might occur. It is recommended that self-insurance progams be carefully researched, designed, and managed. (14 references) (SI)

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ED308607

A Look at Self-Insurance through Pooling
and Capital Market Funding

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A Look at Self-Insurance through Pooling and Capital Market Funding

Issue

School business officials are confronted with a long list of insurance needs that are becoming increasingly complex and costly. The insurance crisis of the mid-1980's hit school districts particularly hard both through rate increases and dissolution of coverage. As a result, insurance, especially group hospitalization and related medical care, is the fastest growing cost in school districts. In addition, renewal costs of both property and casualty insurance and liability insurance have been unprecedented over the last five years. There is an ever-increasing need to control costs and to get service for what is purchased.

Because the risk management needs of schools have not been adequately addressed by the insurance industry, school district officials must find alternatives which address these needs. Although there are several options to be explored, this paper focuses on one viable alternative: self-insurance, either through pooling or capital market funding.

When districts self-insure, they usually fund for each potential loss (or a portion of that loss) and purchase insurance for excessive claims. Several approaches to self-insurance are possible. Large districts can usually self-insure independently, but several districts can pool together to spread the risk among several members who combine resources. A capital market approach to self-insurance involves creating a reserve fund with debt proceeds.

Points of View

Several writers addressed school insurance issues in recent years; however, the literature dealing specifically with self-insurance through pooling and capital market funding is sparse.

Thomas Maedke noted that self-insurance gained momentum because of premiums savings, improved coverage, and desirable insurance limits. He estimated that 50 percent of all premium dollars from property and casualty insurance will be self-insurance by 1989 compared to 7 percent in the late 1960's.¹ Ronald Boggs suggested that school districts look into self-insurance and pooling programs.²

Maedke further suggested that districts start with property and casualty insurance and later consider health, life, and accidental death coverage. He urged districts to self-insure areas where insurance cannot be purchased such as asbestos and pollution hazards and sexual molestation by charging a premium and depositing it in an interest-bearing account.³ This position suggests the creation of a reserve fund.

As Rakich noted, the idea of contributing to a common fund to finance risks formed the basis for insurance. Yet school district pools began only recently. Rakich presented a full discussion of both the advantages and disadvantages of insurance pools. He emphasized that districts must give considerable thought to joining a pool because costs, coverages, and services provided are not always directly comparable. The advantages he recognized included spreading risk among members, stabilizing insurance during market cycles, and providing better and more responsive services. Inequitable distribution of investment earnings, unequal benefits to members, joint and several liability, withdrawal of members, and inability to assess additional funds were disadvantages.⁴

Other advantages of self-insurance mentioned by Maedke were efficient claims management, immediate management information and feedback, greater access to insurance markets, and improved cash management/cash flow where up to 50% of premium dollars can be retained in the pool's interest-bearing account.⁵

Rosenthal noted that pools work best with rather homogeneous members governed by specific regulations. Thus pools provide previously unavailable or unaffordable coverage. The author also summarized reasons for the success and failure of pools.⁶

An existing self-insurance pool discussed by Clark and Hertz was the Florida Community College Risk Management Consortium which was formed by 27 colleges. Because these colleges were not large enough to create a sufficient amount of premium dollars to allow for cost-saving methods, the group was formed to attain services at an acceptable cost. The group took advantage of volume purchasing and spreading the risk over the large group. In the first four years, the consortium saved \$4 million.⁷ This view is favorable toward insurance pools.

Another self-insurance plan was presented by Falkinham: the Waukegan Public School Employees Plan. This plan covered property, liability, and health insurance. Implemented in 1983, the plan had three basic features: (1) in-house district claims processing, (2) a governing board of employees representing various employee groups, and (3) cost containment provisions. The Waukegan Plan has worked well for the district.⁸

A major issue in self-insurance, whether school districts work independently or in pools, is financing. Several writers addressed this problem. Klail suggested that many pools themselves are examining techniques of prefunding for several years. He noted that many municipalities have moved toward pooled lease financing programs for capital expenditures and that school districts might move in the same direction. He explained

this method of financing risk through capital markets as a method of using debt proceeds to finance loss funding. Basically this means issuing long-term debt instruments to create a pool of proceeds that will be available to fund loss. Klail urged school districts to take note of new techniques to finance risk: (1) melding of various financial resources and (2) positioning for high risk retention.⁹

Maedke suggested specific financing structures for pools. He urged districts to develop a loss fund which is derived much the way insurance premiums are developed and to aggregate loss fund protections with an insurance policy to be used only after the established loss fund is exhausted.¹⁰

Two articles suggested the use of capital markets for funding self-insurance. The first, by David Kirschenbaum and Vivian Altman, pointed out that the creation of a reserve fund big enough to cover payment of likely claims is a major challenge of self-insurance. One suggested approach was to build the fund up gradually over a number of years; however, the system would be left vulnerable in the early years. Another option was to capitalize the program at the beginning with a bond issue. These authors outlined the steps needed to capitalize the program. One main point of their plan was for districts to establish a line of credit with a commercial bank to draw upon in the event that a claim exceeded the payment limits established for the program.¹¹

In the second article Rudolph also discussed the capital markets approach to risk financing. He focused on the aspects of stability and control in the capital markets approach and noted real cost savings might also occur because taxes and profit are eliminated. He suggested a method which would start with analysis of financial loss. Some risks would be conventionally insured, and others would be self-insured by borrowing in capital markets. Thus a school district would, in essence, set up its own insurance system into which the district would make regular contributions. Rudolph

suggested breaking the coverage down into property exposures and liability exposures. The author outlined services necessary for self-insuring in this manner.¹² He did not discuss other types of self-insurance; however, the approach he suggested may be extended to other coverages.

Personal Position

In a period of insurance uncertainties related to soaring premiums, cancellations, and cutbacks on coverage, school district officials must address the insurance issue. There is a trend toward self-insurance, but districts should not self-insure before carefully examining their individual positions to determine whether or not they will benefit. There are several significant considerations: (1) coverage can be tailored to specific needs; (2) a district has more control of services; (3) coverage is more stable than through commercial markets; and (4) potential cost savings may be significant.

The ideal situation in setting up self-insurance is on an individual basis through capital markets funding. Districts who can act independently do not have to risk the possible inequities and uncertainties that befall pools. Coverage could be better matched to the needs of the specific district. Yet it is not realistic for all districts to undertake self-insurance on their own because of the cost involved. Pools are a viable alternative if the pools are set up and managed carefully.

The best funding method for self-insurance programs, whether independent or pools, is to capitalize the program through a bond issue. This kind of funding spreads the impact of potential loss over a period of time and allows time to build up permanent reserves. Following an actuarial assessment of the kinds of losses that can be anticipated over a period of time, the appropriate beginning level funding can be determined. In addition to this start-up funding, the district pays yearly contributions to the program, and

investment earnings are used to pay debt-service on the initial funds. This method does not put an excessive burden on the district in any one year. In addition, some savings are realized by eliminating taxes and the profit reaped by the insurance companies.

The one threat in the capital market approach is the catastrophic claim that might occur. To provide for this contingency, two approaches should be considered. First, the district can purchase excess insurance which pays beyond the set limits of the self-insurance and covers the risk of depleting fund reserves. Second, the district may negotiate a line of credit with a commercial bank which can be activated in the case of catastrophe. In either choice, the self-insurance fund is not destroyed.

Self-insurance programs must be carefully researched, designed, and managed. It is not recommended that a district initiate self-insurance for all insurance needs at once. Rather a district should begin self-insurance with property and liability insurance. This first phase should be solvent before determining whether or not self-insurance should be extended to health, worker's compensation, death, and other areas. After implementing the first phase, a district can also evaluate the administrative costs of self-insurance.

School districts who are experiencing rising costs or inadequate coverage through conventional insurance should consider self-insurance because of the advantages such a program offers. Through self-insurance a district writes its own customized policy. Another advantage is that self-insurance usually results in more efforts to reduce loss. With loss reduction and better risk management, costs of insurance decline. Any savings realized result in dollars that can be spent elsewhere.

Notes

¹Thomas F. Maedke, "Cooperative Purchasing of Insurance and Risk Management Services," School Business Affairs June 1988: 35-36.

²Ronald Boggs, "Working with the Insurance Market in Turmoil," School Business Affairs June 1985: 55-56.

³Maedke 36-37.

⁴Ronald Rakich, "Before You Jump into the Pool-check the Water!," School Business Affairs June 1985: 40-43.

⁵Maedke 37-39.

⁶Samuel L. Rosenthal, "Self-Insurance Pools: Fantasy or Reality?," School Business Affairs June 1987: 19-20.

⁷James E. Clark and Earl V. Hertz, Major Topics of School Business Management in the Mid-1980's, ERIC, ED 279-901, 65-68.

⁸Ken Falkinham, Self-Insurance (Waukegan Style), ERIC, EA 018 796, 3.

⁹Milton C. Klail, "Financing Risk Through Capital Markets," School Business Affairs, June 1988: 16-17.

¹⁰Maedke 37.

¹¹David Kirschenbaum and Vivan Altman, "School Bond Power Lets You Create Self-Insurance Reserves," The Executive Educator, November 1988: 19-20.

¹²Richard Rudolph, "Risk Financing for Schools: The Capital Markets Approach," School Business Affairs, June 1988: 27-31.

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